Islamic banks and their Accounting practices

Dissertation Submitted for the partial fulfillment of the requirements for the degree of Bachelor Business Administration

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Major Subject: Accounting

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All Praise and thanks are Allah's who makes it possible to complete our graduation project successfully and easily and many thanks due to Allah for all things, especially for giving me the strength, health, and intellectual capability to accomplish this task.

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In the name of Allah, the most Merciful, the most Compassionate

And that which you give in gift (loan) (to others), in order that it may increase (your wealth by expecting to get a better one in return) from other people's property, has no increase with Allah; but that which you give in Zakāt (sadaqa - charity etc.) seeking Allah's Countenance, then those, they shall have manifold increase.

(Sura Al-Rum 30:39)
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Introduction

Islamic banking has established itself as an emerging alternative to interest based banking and has grown rapidly over the last two decades both in Muslim and non-Muslim countries. Islamic banks have recorded high growth rates in both size and number and operate in over countries worldwide and bankers predict that Islamic banking could have control over 50% of savings in the Islamic countries within the next decade. (Ahmad, 2004) The practices and activities of Islamic banks reflect the environment in which they are based. There are strong retail operations in Iran and Saudi Arabia. In the secular societies of northern Africa, Islamic banks compete on the quality of products rather than on religious grounds. In Kuwait, financing has focused on the petroleum sector and real estate investment and in the United Arab Emirates, the emphasis is on trade and finance (Zaher and Hassan, 2001)
According to the American economic development council (1984), “Economic development is the process of creating wealth through the mobilization of human, financial, capital, physical and natural resources to generate marketable goods and services”. The concept of the Islamic economic system as described in all its aspects focuses on the worship of the creator, which includes man’s duty to develop life on earth, thus securing a decent standard of living for the individual. Islam stresses that man is the principle agent for developing life on earth and hence the development of man is required condition for the development of society. (El-Ghazali, 1994) The large number of economic ills, including poverty, social and economic injustice, inequalities of income and wealth, economic instability and inflation of monetary assets are all in conflict with the value system of Islam. It is the responsibility of the money and banking system to contribute to the achievement of socio-economic development and hence eliminate such economic ills. The principle goals and functions of the Islamic banking system include economic well-being with full employment and maximum rate of economic growth, equal distributions of income and wealth and as a result socio-economic justice, and the generation of sufficient savings and their productive mobilization and stability in the banks.

During the last decade and a half, Islamic banking has made significant progress. At present, more than 50 Islamic banking institutions are working indifferent parts of the world and at least three countries have not only declared their intentions but have also taken some necessary steps to reorganize their entire banking system along Islamic lines. The successful operation of Islamic banks in several parts of the world has led to a growing interest in Islamic financing techniques. Do Islamic banks really have something new to offer? Are the functions, activities and banking techniques of Islamic banks any different from those of conventional commercial banks? If yes, in what respect do they differ? What are the similarities or dissimilarities with respect to these activities among Islamic banks themselves? These and similar other questions are generally raised whenever the subject of Islamic banking is mentioned. The raison d'être of Islamic banking is derived from the Islamic injunction against Riba (interest). Islam prohibits interest on loans regardless of their nature or purpose. During the late nineteenth and early twentieth century when the Muslim world first
came into contact with industrialization and such related economic and financial institutions as commercial banking, some attempts were made to dilute the strong injunction against Riba. It was argued that Riba which is condemned and prohibited by the Qur'an is really usury and not interest which is the basis of modern banking. It was also held that the prohibition of Riba is mainly aimed at eliminating the excesses and exploitation involved in the consumption loans; when given on interest. Since banks primarily grant loans for productive purposes, the prohibition of Riba may not cover bank loans. However, these views were held by a small minority in Muslim countries and were not accepted by the majority of Muslims who had serious reservations about the correctness of these positions and the permissibility of interest. In contrast to interest based banking, Islamic banking is not based on the notion of a predetermined fixed return on capital.

The Islamic prohibition against interest does not imply in any way that capital is free or that it should be made available without cost or that there should be no return on capital. In fact, Islam allows a return on capital, provided that capital participates in the productive process and is exposed to business risk. Muslim economists have generally held that commercial banking in an Islamic state should be organized on the basis of some form of profit sharing, represented by Mudarabah and Musharakah. However, Islamic banking as it has developed and is developing is not solely based on Mudarabah and Musharakah. It also uses a number of other contracts permissible by Islam in order to conduct its banking business. The elaboration and explanation of these techniques is the subject of this paper.

According to theoretical models developed by Muslim economists, Islamic banking based on the principle of Mudarabah claims to be superior to interest based commercial banking in terms of equity, efficiency, stability and growth. In comparison to other financial systems, Islamic banking will be more just because the contract of Mudarabah is based on the principles of justice and equity. It will be more efficient as it will help attain a more rational and balanced allocation of financial resources among the competing projects because the main consideration in the allocation of funds under Islamic banking would be the profitability of relevant projects and not the safe return of the principal amount as in the case of conventional banking. In other words, bankable projects would be selected on the basis of profitability and not on the criterion of creditworthiness. Islamic banking will also safeguard against business fluctuations as it has more potential of being linked to the
productive capacity of the economy. Hence, the cost of capital as well as the amount advanced for further investment would adjust themselves in accordance with changes in the business environment. Furthermore, it will also promote growth as it would increase the supply of risk capital for investment. While much discussion has taken place and a good deal of literature has accumulated on the justification of the prohibition of Riba in Islam and various conceptual issues of Islamic banking of contemporary Islamic banks.

**Review of literature:**

Many researchers and professionals in the banking and accounting research in this subject, whether on the scope of the Arab or Islamic, and we will review some of them:

- **Study (OMAR, 1997):**
  The purpose of this study is to analyze the reality of the Islamic banking industry, and to shed light on the most important terms of the agreement with influence on the Islamic banking industry and the analysis and anticipation of these effects of negative and positive benefits with an indication of practical guidance for the response, the study found the necessity to do procedures that help Islamic banks on fair competition with Western financial institutions.

- **Study (Albeltage, 1997):**
  This study intend to find criteria for evaluating the performance of Islamic banks to identify the extent of success of Islamic banks. the study finds that there are no accounting standards for use in evaluating the performance of Islamic banks, prompting bank of the Islamic.

- **Study (Abu Obeid, 2000):**
  In this study, an analysis of the sources of funds of Islamic banks and aspects of their use, then focus on the extent of integration of services offered by Islamic banks, and discuss the nature of the relationship between the Islamic banks on the one hand, and all of central banks and banks commercial on the other. He knew the risks facing the work of Islamic banks and introduced a set of recommendations, including development and modernization of the bond market "instruments" of the Islamic as a financial instrument acceptable legally to mobilize savings, which would contribute to strengthening the work of Islamic banks and employing excess liquidity and reduce risk, and rehabilitation of the financial markets in Islamic countries.

:Problems of the Study
The current study aims at investigating the following problems based on finding alternatives of Islamic banks:

1. What is the concept of Islamic Banks
2. What is the concept of accountancy system of Islamic Banks
3. What are the main differences between Conventional banks And Islamic Banks in the aspect of accountancy system
4. What are the challenges facing Islamic banks and their empirical extent of success in Saudi area

**Objectives of the study**

The current study aims at achieving the following objectives:

1. Highlighting the concepts of Islamic Banks as well as their nature and objectives
2. To study and describe the Islamic financing techniques used by various Islamic banking institutions
3. To study the differences in the use of these financing techniques by different Islamic banks
4. Casting new light of Islamic Banks and accountancy systems
5. Success of Islamic banks and their Challenges

To meet the foregoing stated objectives the following research questions are raised to find out to what extent:

1. What are the characteristics and objectives of Islamic Banks
2. What are funding ways of Islamic Banks
3. What are the challenges that face the Islamic Banks
4. What is the Islamic banks' experiment success

**Hypotheses:**

To answer the research questions these hypotheses are postulated:

1. There are the characteristics and objectives of Islamic Banks
2. There are funding ways of Islamic Banks
3. There is the Islamic banks' experiment success
4. There are salient the challenges that face the Islamic Banks
Chapter ONE

Islamic banking: Historical & Economical

Introduction to Islamic banking

In 1963, Islamic banking came into existence on an experimental basis on a small scale in a small town of Egypt. The success of this experiment opened the doors for a separate market for Islamic banking and finance and as a result, in 1970s Islamic banking came into existence at a moderate scale and a number of full-fledged Islamic banks was introduced in Arabic and Asian countries later on. Islamic banks and non-banking financial institutions are now in operation even on more intensive scale. Today, Islamic banks are operating in more than sixty countries with assets base on more than $166 billion and a marked annual growth rate of 10%-15%. In the credit market, market share of Islamic banks in Muslim countries has risen from 2% in the late 1970s to about 15 percent today (Rajesh, Aggarwal and Yousaf, 2000). Islamic banking in Pakistan started around three decades after its first introduction on experimental basis in a small town of Egypt in 1963, many Islamic Banks, both with letter and spirit, were established in the Middle Eastern and Asian regions. The growth of Islamic banking has been increasing ever since, not only in terms of number of countries it is operating in but also in term of areas of finance it has ventured in (El Gamal, 2006). In three decades, Islamic banks have grown in number as well as in size worldwide and are being practiced on even more intensive scale. Some countries like Sudan and Iran, have converted their entire banking system to Islamic banking. In other countries where conventional banking is still dominating the Islamic Banking is operating alongside. Today, Islamic banks are operating in more than sixty countries (Aggarwal and Yousaf 2000). Islamic Banking and Finance is growing at between 10%-15% per annum and is boasting global assets in excess of $1Trillion. A recent survey indicated that there are more than 160 Islamic financial institutions existing worldwide (Dar
Gradual and steady spread of the Islamic banks over time over the world is a lucid manifestation of success and the symbolic growth rate is the hallmark of this emerging market. Being fastest growing segment of the credit market in Muslim countries, market share of Islamic banks in Muslim countries has risen from 2% in the late 1970s to about 15 percent today (Aggarwal and Yousaf 2000). Islamic banking is getting popularity, warm welcome, and appreciation also by non-Muslims in Muslim and non-Muslim countries. According to Yudistira (2003), although, most of the Islamic banks are within Middle Eastern and/or Emerging countries, many universal banks in developed countries have started to spigot huge demand of Islamic financial products. This also confirms that Islamic banking is as viable and efficient as the conventional banking is. Where the financial liberalization and deregulation have created new challenges and new realities for Islamic banks, the globalization effect has also put these institutions in cutthroat competition with traditional financial institutions in well developed financial markets. It has become indispensable for Islamic banks to be innovative in designing Islamically acceptable instruments to grapple with the unremitting innovations in financial markets and to compete in local and global deposit markets. Moreover, for fund mobilization and utilization, Islamic banks must seek investment opportunities and avenues that offer competitive rates of return at acceptable degrees of risk. In order to maximize the value of the bank, management of the bank should carefully consider interactions between different performance measures.

Islamic finance refers to the means by which corporations in the Muslim world, including banks and other lending institutions, raise capital in accordance with Shari’ah, or Islamic law. It is also referred to the types of investments that are permissible under this form of law. A unique form of socially responsible investment, Islam makes no division between the spiritual and the secular, hence its reach into the domain of financial matters (Ross 2007).

Section 2 Islamic banking in the Eyes of Islamic Law

According to Islamic Shari’ah the Islamic banks are bound to follow instructions of Allah Almighty on all transactions, particularly involving exchange of money for money. However, it would be quite unfair to limit Islamic banking to elimination of
Riba only. Riba is but one of the major undesirable elements of an economic transaction, the others being Gharar (risk or uncertainty) and Qimar (speculation). While elimination of these objectionable aspects in a transaction is indeed a critical aim of Islamic banking, it is by no means its ultimate objective. As in Islam the more emphasis is given to Riba free transactions and that emphasis are given in different points of Muslims’ holy book Quran, “That they took riba (usury), though they were forbidden and that they devoured men’s substance wrongfully – We have prepared for those among men who reject faith a grievous punishment. Sura An-Nisa (4:161)”. At another point such type of arguments are passed in sura Bagra “O ye who believe! Be afraid of Allah and give up what remains (due to you) from Riba (usury) (from now onwards) if you are (really) believers. (2:278).” “And if you do not do it, take notice of war from Allah and His messenger! But if you repent, you shall have your capital sums. (2:279).” However, this does not mean that Islam prohibits any gain on principle sums. In Islam, profit is the recognized reward for capital. When capital employed in permissible business yields profit that profit (excess over capital) becomes the rightful and just claim of the owner of the capital. But, the risk of loss also should be there. Another important element of Islamic finance is that profit or reward can only be claimed in the instance where either risk of loss has been assumed. Profit is therefore received by the provider of capital and wages/remuneration by labor/ manager.

Islamic banking has been defined as banking in consonance with the ethos and value system of Islam and governed, in addition to the conventional good governance and risk management rules, by the principles laid down by Islamic Shari’ah. Interest free banking is a narrow concept denoting a number of banking instruments or operations, which avoid interest. Islamic banking, the more general term is expected not only to avoid interest based transactions, prohibited in the Islamic Shari’ah, but also to avoid unethical practices and participate actively in achieving the goals and objectives of an Islamic economy\(^1\). Islamic banking is the system of banking consistent with principles of Islamic law (Shari’ah) and guided by Islamic economics. Islamic economics is referred to that body of knowledge which helps realize human well-being through an allocation and distribution of scarce resources that is in

\(^1\)(Source: SBP)
conformity with Islamic teachings without unduly curbing individual freedom or creating continued macroeconomic and ecological imbalances (Chapra 1996). A key element of Islamic economics is distribution of equitable rewards to the different factors of production. Islamic economic system seeks system of Redistributive justice where concentration of wealth in a few hands is countered and flow of money into the economy is fluent. Islamic banking is, therefore, seen as a lynchpin to achieving the economic and social goals of the Islamic economic system.

As system of Islamic banking is grounded in Islamic principles and all the undertakings of the banks follow Islamic morals so it could be said that financial transactions within Islamic banking are a culturally-distinct form of ethical investing. Two basic principles behind Islamic banking are the sharing of profit and loss and, significantly, the prohibition of Usury, the collection and payment of interest, also commonly called Riba in Islamic discourse. Although collecting and paying interest is not permitted under Islamic law, revenue-sharing arrangements are generally permitted. "Way to the water." The "way" of Islam in accord with the Qur'an and Sunna, Iijma' and Qiyas. Sharia is the law of Islam. An investment that is considered socially responsible because of the nature of the business the company conducts. Common themes for socially responsible investments include avoiding investment in companies that produce or sell addictive substances (like alcohol, gambling and tobacco) and seeking out companies engaged in environmental sustainability and alternative energy/clean technology efforts.

The thrust of Islamic banking is founded on the desire to submit to the Divine Instructions on all transactions, particularly those involving exchange of money for money. However, it would be quite unfair to limit Islamic banking to elimination of Riba only. Riba is but one of the major undesirable elements of an economic transaction, the others being Gharar (risk or uncertainty) and Qimar (speculation). While elimination of these objectionable aspects in a transaction is indeed a critical

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2(Source: Bank Alfalah).

3(Source: Islamic Dictionary)

http://www.investopedia.com/articles/07/islamic_investing.asp
aim of Islamic banking, it is by no means its ultimate objective. According to some, 
usury or excessive and exploitative charging of interest; while according to others, 

:interest per se – is forbidden by the Qur'an. For example 

_And that which you give in gift (loan) (to others), in order that it may increase (your “
wealth by expecting to get a better one in return) from other people’s property, has no
increase with Allâh; but that which you give in Zakât (sadaqa - charity etc.) seeking
Allâh’s Countenance, then those, they shall have manifold increase._

_Sura Ar-
Rum_

_That they took riba (usury), though they were forbidden and that they” ”._

_(30:39)_

_devoured men’s substance wrongfully – We have prepared for those among men who
"

_(reject faith a grievous punishment. Sura An-Nisa (4:161)_

It has been argued in vain for long in some circles that the prohibition in Islam is 
that of excessive interest only or that it is the interest on consumptive loans that has 
been forbidden and as such loans extended for commercial purposes are entitled to an 
excess over the principle amount lent. Such tendentious arguing fails to give due 

_ (understanding to versus 278 & 279 of Surah Albaqra (quoted below _

_O ye who believe! Be afraid of Allah and give up what remains (due to you) from “
Riba (usury) (from now onwards) if you are (really) believers. (2:278).” “And if you
do not do it, take notice of war from Allah and His messenger! But if you repent, you
"

_.(shall have your capital sums. (2:279)_

However, this does not mean that Islam prohibits any gain on principle sums. In 
Islam, profit is the recognized reward for capital. When capital employed in 
permissible business yields profit that profit (excess over capital) becomes the rightful 
and just claim of the owner of the capital. As a corollary, the risk of loss also rests 
exclusively with the capital and no other factor of production is expected to incur it. 
Another important element of Islamic finance is that profit or reward can only be 
claimed in the instance where either risk of loss has been assumed or effort has been 
expended. Profit is therefore received by the provider of capital and 

_.wages/remuneration by labor/manager_

Prophet Muhammad (Peace be upon Him). The Qur’an and the example of Prophet 
Muhammad (Peace be upon Him) provide direct behavioral guide and represent 
bedrock of Islamic faith to over one billion Muslims globally. The Prophet 
Muhammad (Peace be upon Him) happened to be a businessman serving as a trader
for Khadija (May Allah be pleased with Her). The Prophetic example was the very epitome of fair-trade. Refraining from usury, ensuring transparency in transactions, and total honesty entitled him Al- Amin (The trustworthy) in pre-Islamic Arabia (Sufyan7). In Muslim communities, limited banking activity, such as acceptance of deposits, goes back to the time of the Prophet Muhammad (Peace be upon Him). At that time people deposited money with the Prophet Muhammad (Peace be upon Him) or with Abu Bakr Sedique (May Allah be pleased with Him), the first Khalif of Islam. In order to avoid manifestation of Islamic fundamentalism which was anathema to the political regime, the first modern experiment with Islamic banking was undertaken in Egypt under cover without projecting an Islamic image. Ahmad El Najjar made pioneering effort and established a Savings Bank based on profit-sharing in Egyptian town of Mit Ghamr in 1963. There were nine such banks in the country by 1967. These banks, which neither received nor paid any interest, invested mostly by engaging in trade and industry, directly or in partnership with others, and shared the profits with their depositors (Siddiqi 1988). These banks were functioning essentially as saving-investment institutions rather than as commercial banks. Although its charter made no reference to Islam or Shari’ah (Islamic law), Nasir Social Bank, established in Egypt in 1971, was declared an interest-free commercial bank (Arif 1988). In the seventies, because of changes that took place in the political climate of many Muslim countries, there was no longer any strong need to establish Islamic financial institutions under cover. Both with letter and spirit, a number of Islamic banks were established in the Middle East, e.g., the Dubai Islamic Bank (1975), the Faisal Islamic Bank of Egypt (1977), the Faisal Islamic Bank of Sudan (1977), and the Bahrain Islamic Bank (1979), to mention a few. A number of banks were also established in the Asia-Pacific region in response to these winds of change, e.g., The Philippine Amanah Bank (PAB) was established in 1973 as a specialized banking institution by Presidential Decree without reference to its Islamic character in the bank's charter. The PAB is not strictly an Islamic bank; nevertheless, Ismail, Gulam Sufyan, “Islamic finance explained” Section.3 Difference between Islamic and Conventional Banking

Islamic banking and conventional banking differs in different aspects like,
1. Conventional banking follows conventional (interest-based) principle while the Islamic banking is based on interest free principle and principle of Profit-and-Loss (PLS) sharing in performing their businesses as intermediaries. Rationale behind prohibition of interest and the importance of Profit-and-Loss (PLS) sharing in Islamic banking has been discussed in many Islamic economics studies. Moreover, Islamic PLS principle creates the relationship of financial trust and partnership between borrower, lender, and intermediary (Yudistira 2003).

2. Islamic finance is a financial system with the aim to fulfill the teaching of Holy Quran as opposed to getting maximum return on financial assets. Islamic ethical norms are the main concern of Islamic financial system. These norms of Islamic ethics are stated by the Shari'ah govern all transactions in an Islamic financial system. At a basic level, an Islamic financial system can be described as a “Fair” and a “Free” system where “Fairness” is the primary objective.

3. An Islamic bank is essentially a partner with its depositors, on the one side, and also a partner with entrepreneurs, on the other side, when employing depositors' funds in productive direct investment as compared to a conventional bank which is basically a borrower and lender of funds (Suleiman 2001). Islamic banks compared with non-Islamic banks seek a “just” and “equitable distribution of resources”. Islamic bank is based on Islamic Faith and its operations must be within the boundaries of Islamic Law or the Shari'ah. There are four rules that govern investment behavior (Suleiman 2001).

   a. The absence of interest-based (RIBA) transactions;
   b. The avoidance of economic activities involving hypothesis (GHARAR);
   c. The introduction of an Islamic tax, ZAKAT;
   d. The discouragement of the production of goods and services which is prohibited (HARAM) in Islam.
Chapter TWO

Instruments OF Islamic banks

Section.1 Introduction

All the monotheistic religions have their own sets of divine values and norms with regard to human behavior, in particular economic behavior. Islam, with its 1.2 billion followers is the second largest religion in the world and it requires Muslims to lead their lives according to the Islamic legal code of ‘Shariah’ principles. Commerce is central to the Islamic tradition (Warde 2000). The prohibition of *riba*, a term literally meaning an excess and interpreted ‘as any unjustifiable increase of capital whether in loans or sales’ is the central tenet of the Islamic economy. This prohibition is based on arguments of social justice, equality and property rights.

There are about 250 Islamic financial institutions worldwide with more than $200 billion under their management. These Islamic banks have been growing at a rate of around 10% p.a. over the last decade (Iqbal 2000). Their clientele is not confined to Muslim countries but is spread over Europe, the United States and the Far East. Realizing the potential of this emerging form of banking numerous conventional banks started ‘Islamic windows’. Islamic banking continues to grow at a rapid pace because of its value-orientated ethos, enabling it to draw finances from both Muslims and non-Muslims alike. At the same time, Western attitudes are changing, as can be seen in the recent growth of ‘ethical’ banking, where (non-Islamic) customers refuse to invest in companies engaged in unethical and socially harmful activities (e.g. armaments or tobacco). Describing the Islamic financial system simply as interest-free does not provide a comprehensive picture. Some key instruments of Islamic banking are briefly discussed below.
Section. 2 Instruments of Islamic banking

2.1 Murabaha

A kind of “cost-plus” transaction in which the bank buys the asset then immediately sells it to the customer at a pre-agreed higher price payable by instalments. This facility is often used in the way that mainstream banking customers might seek a mortgage when buying property. The most preferred method of financing for many Islamic banks due to the simplicity of the model. Murabaha has no direct effect upon poverty reduction, but indirectly it provides a good tool for an efficient deferred sale, providing business men the asset of its choice and providing banks profit for the effort and risk that it tool. Murabaha has little effect on the reduction of unemployment; there is no clear study on the effect of Murabaha on inflation.

Under murabaha, the Islamic bank purchases, in its own name, goods for an importer or buyer who cannot afford to pay directly, and then sells them to him at an agreed mark-up. This is the sale of a commodity at a price, which includes a stated profit known to both vendor and purchaser (a cost plus profit contract). This technique is usually used for financing trade, but because the bank takes title to the goods, and is therefore engaged in buying and selling, its profit derives from a real service that entails a certain risk, and is thus seen as legitimate. Simply advancing the money to the client at a fixed interest rate would not be legitimate. Only a legitimate profit is considered lawful under Islamic law; any excessive addition on account of deferred payments would be disallowed as it would amount to a payment based on the value of money over time i.e. interest.

To sum up Murabaha has also good effect on reducing inflation, as it involves use of agency contract with proposed borrower who can buy goods of its demand, at discounted or lowest possible price for its proposed lender as agent, it ensures that lowest prices are used in contract, no need of borrowed interest based loans for borrower, and so

2.2 Mudaraba

Form of investment partnership between a bank and a business that shares the risk and losses/profits between both parties at pre-agreed levels. A mudaraba transaction, bringing some of the benefits of a business loan to shariah-compliant
business customers, effectively requires the bank to take a stake in the business, with clients investing their time and expertise in running the enterprise.

Mudarabah is a very potent tool for removing interest from the society by providing an interest free tool for skill utilization and it can especially help in mobilizing resources of the society by employing them as a manager, while banks will provide the finance and also bear the chances of profit and loss, which is absent in interest based financing for venture capital. Mudarabah has a significant effect on reducing the unemployment in both the short and long run, as it encourages business management by skilled people and promotes commercial activity. Mudarabah also helps control inflation by promoting interest free business activities. Interest and credit creation of banks through lending are the major source of inflation in society. Mudarabah involves bank or other capitalists bearing in both profit and loss, and not just making earnings through a predetermined interest rate exploiting the needs of individuals or firms.

This implies a contract between two parties whereby one party, the rabbul-mal (beneficial owner or the sleeping partner), entrusts money to the other party called the mudarib (managing trustee or the labour partner). The mudarib is to utilize it in an agreed manner and then return to the rabbul-mal the principal and the pre-agreed share of the profit. The mudarib (bank) keeps for itself what remains of such profits. The division of profits between the two parties must necessarily be on a proportional basis and cannot be a lump sum or guaranteed return. The investor is not liable for losses beyond the capital he has contributed. The mudarib does not share in the losses except for the loss of time and effort.

\textit{Mudharabah} is a profit sharing arrangement between two parties, that is, an investor and the entrepreneur. The investor will supply the entrepreneur with funds for his business venture and gets a return on the funds he puts into the business based on a profit sharing ratio that has been agreed earlier. The principle of \textit{Mudharabah} can be applied to Islamic banking operations in 2 ways: between a bank (as the entrepreneur) and the capital provider, and between a bank (as capital provider) and the entrepreneur. Losses suffered shall be borne by the capital provider.

You supply funds to the bank after agreeing on the terms of (1) the \textit{Mudharabah} arrangement (2) Bank invests funds in assets or in projects (3) Business may make profit or incur loss.
Profit is shared between you and your bank based on a preagreed ratio. Any loss will be borne by you. This will reduce the value of the assets/investments and hence, the amount of funds you have supplied to the bank. 

To sum up Mudaraba has an effect on reducing the business sector unemployment, as it encourages business management by skilled people and promotes commercial activity, unemployment is reduced with it in short and long run both. Mudaraba also helps controlling inflation by promoting interest free business activities. Interest and credit creation of banks by lending are the major source of inflation in society. Mudaraba puts a great check on it by involving bank or other capitalist engaged in profit and loss both, not earning predetermined interest exploiting the needs of business or management of firm.

2.3 Musharaka: This is a partnership, normally of limited duration, formed to carry out a specific project. It is similar to a Western joint venture, and is also regarded by some as the purest form of Islamic financial instrument, since it conforms to the underlying partnership principles of sharing in, and benefiting from, risk. Participation in a musharaka can either be in a new project, or by providing additional funds for an existing one. Profits are divided on a pre-determined basis, and any losses shared in proportion to the capital contribution.

Every Islamic bank has a committee of religious advisers whose opinion is sought on the acceptability of new instruments and who provide a religious audit of the bank's accounts. In Islam moral and equitable values form an integral part of the law governing contractual and financial relations to such an extent that the relationship between equity, law and religion is central to all business. Table 1 compares the Islamic financial instruments and practices with those of conventional banking.

To sum up: Musharkah also creates jobs for many people in society, being finance based mode, promotes enterprise and partnership ventures, creating jobs in the country. No direct effect but promotes business enterprise culture in society, growth of skilled people is needed so may be helpful in growth of literacy. Moreover, financing a school or university via musharaka may be helpful for its management extending its facilities.
Ijarah (Leasing)

A form of shariah law-compliant leasing involving the rights over the use of an asset under which the bank buys the asset then leases it to the customer over a fixed period in return for a pre-agreed monthly price. Provisions can be made for the customer to buy the asset at the end of the agreed period. Thought needs to be given to issues such as the provision of insurance, as the asset is effectively owned by the bank during the lease period. Ijarah has no direct effect upon poverty reduction and has a little effect on reducing unemployment. However, it has great potential for protecting against inflationary harms to middle class people and entrepreneurs, by allowing the use of assets without sudden cash outflows. It enables them to modify or replace, even after some months or years, their equipment or machinery without much cash flow swings. But Ijarah, like ordinary lease, can sometimes lead to inflation itself if the economy is working at the full employment level, then boosting demand of goods which will further increase prices in the market.

Istisna

Istisna, another form of forward sales contract, is a longer-term financing mechanism under which a price is agreed before the asset described in the agreement is actually built. Sellers can then either create the asset themselves or subcontract, with buyers also having the option of paying the entire sum due either in advance or as installments during the manufacturing process. Istisna is especially useful in the housing sector, boosting the construction demand creating employment and wealth to society without harmful effects of interest. It has also good effects on the reduction of unemployment by boosting construction and house building activities in society. Istisna has a little effect on inflation control.

Salam

A kind of forward sales contract which requires the buyer to pay in advance for goods that are to be supplied later. Salam is very useful in reducing agricultural sector poverty easily, by enabling the banks and farmers to contract with each other of the crops and to get finance at an appropriate time, instead of usurious loans, which ultimately deteriorates through the compounding of interest. Salam also has great potential in reducing rural sector...
unemployment and reduces trend towards urbanization, by enabling farmers and agriculturists to work. Salam engages them at villages and towns, thus decreasing the unemployment burden. This generates agricultural and rural sector development and eventually more income for these poor people. Salam has a great effect on reducing inflation, where food stuff has reached its peak prices, the main way it cuts inflation is through ensuring increased aggregate supply and reduce food product deterioration by use of pesticide and fertilizers at appropriate times, boosting the yield of land and farms to much extent.

The effect of a bank’s activity on economic growth will therefore depend on which modes of finance and investment the bank undertakes most, and how much each one of these modes contributes to economic growth. At present, fixed return modes of financing are dominating usage by most Islamic banks – modes such as Murabah and leasing. Even though these are clearly distinguishable from interest-based modes, as transactions are always done through real commodities, they do not yield the full benefits in terms of promoting growth with equity which is expected of an Islamic financial system. Specialists in Islamic financial theory had counted on Islamic banks to provide a significant amount of profit-sharing finance, which would have had economic effects similar to direct investment and would have produced a strong economic development impact. However, due to practical difficulties, profit-sharing finance has remained negligible (in the operations of Islamic banks (Al Hallaq, 2006).

There is much more inequality in the distribution of income and wealth today than there has ever been in the past, both within and between nations. Inequality is growing and this is regarded as a threat to social and economic stability. A large part of the blame is laid on the monetary and financial system. This practice has its origins in the fact that western banking institutions have profitability rather than social imperatives as their primary concern. The result of such practices is unequal income distribution, highly skewed towards the wealthier portion of society, and unjustly deprives non-property holders of gaining access to finance. According to the World Bank Research Observer (1996), commercial banks prefer to lend to low-risk activities and are reluctant to finance high risk projects, even if such projects present better investment opportunities. They are also less willing to finance small firms that don’t have adequate collateral. In contrast, fostering serious
economic development is a key objective of Islamic banks as they seek to maximize social benefit. Islamic banks therefore work hard to overcome shortages and difficulties to help the economy to progress to a higher stage of self-sustained development, resulting in a favorable effect on socio economic harmony due to equal income distribution.

It has been widely claimed by development economists that policy and resource allocation is strongly focused on large firms and that existing banking institutions prefer to grant credit facilities to clients who are able to offer sufficient collateral security.

According to Abdouli (1991), Kahf, Ahmad and Homud (1998), Siddiqi (2002), and Iqbal (1997), maximizing of profitability is not the only concern for Islamic banking institutes and the principles that Islamic banks are based on are deeply integrated with ethical and moral values. They also state that Islamic Banks do not depend on tangible collaterals and lead to a better distribution of income, allowing access to finance for those in poorer classes of society, and resulting in greater benefits for social justice and long term growth.

In contrast with conventional methods, Islamic financing is not centered only around creditworthiness but rather on the worthiness and profitability of a project, and therefore recovering the principle becomes a result of profitability and worthiness of the actual project. Entrepreneurship and risk sharing are therefore promoted by Islamic finance and its expansion to the unwealthy members of society is an effective development tool. The social benefits are clear, as currently the poor are often exploited by financial institutions charging usurious rates. (Iqbal, 1997)

The nature of Islamic banking operations are directly affected by the success or failure of client enterprises as a result of the profit-loss-sharing process (Abdouli, 1991). The relationship is based on a partnership, with cash being entrusted to bankers for investment, and returns shared between depositors and bankers. Losses are carried by fund owners. This sharing principle is very different to traditional banking practices. It introduces the concept of sharing to financing and creates a performance incentive within the mind of bankers that relates deposits to their performance in the use of funds. This increases the deposit market and gives it more stability (Kahf, 2002). Iqbal (1997), Martan, Abdul-Fattah, Jabarti, and Sofrata (1984), and
Ziauddin (1994) are of the opinion that Islamic bankers encourage people to invest as investment depositors receive a share in the bank’s profits. Investors are motivated by the human desire toward ownership, high rewards and the satisfaction of being part of a successful project (Martan et al, 1984). Issuers of Islamic finance have wider latitude in financing services and negotiate a profit share between zero and 100 when dealing with savers and investors. This allows them to better mobilize resources and attract investors as a higher profit share results in lower finance costs (Ziauddin, 1994).

According to Iqbal (1997), the economic development of Islamic countries can be greatly enhanced by the Islamic financial system due to the mobilization of savings that are being kept away from interest based banks and the development of the capital markets. This motivation to invest in Islamic banks may also stem from the fact that research shows that the share in the bank’s profits may at times be higher than the fixed rate of interest given by conventional banks. Some of the literature on Islamic banking states that replacement of interest by profit loss-sharing may result in high instability of the entire economic system as problems originating in one part of the economy will rapidly spread to others. However the general consensus is that interest-free banking tends to enhance stability and it is in fact interest based debt financing that contributes to economic instability.

Islamic finance allows a closer link between real economic activity that creates value and financial activity to be forged. According to Iqbal (1997), the Islamic financial system can be expected to be stable due to the elimination of debt financing and enhanced allocation efficiency.

Analytical models show that the Islamic banking system is stable as the term and structure of liabilities and assets are symmetrically matched through profit-sharing, lack of fixed interest costs and the impossibility of refinancing through debt (Yusri, 2005). Chapra (1992), Kahf (1982), Siddiqi (1983) and Zarqa (1983) all support the idea that profit sharing is more stable than the interest based system resulting in prevention of fluctuations in rates of return. It has been pointed out that interest based debt financing is a major factor in causing economic instability in capitalist economies. As soon as the bankers find that business concerns are beginning to incur losses they reduce assistance and call back loans (Yusri, 2005). In an Islamic banking system more stability is experienced as in times of crisis investment depositors automatically share the risk due to profit-and-loss sharing, meaning that individual
banks as well as the entire banking system is less likely to break down (Zaher and Hassan, 2001).

The focus of Islamic finance on profitability and rate of return of investments due to equity and profit sharing has the potential of directing financial resources to the most productive investments and hence increases the efficiency of the financing process and in the real sectors (Kahf et al, 1998). Economic development requires mobilization of financial resources both internally and externally and any resources left hoarded indicate unrealized potential for economic development. Qureshi (1984) and Nagvi (1981 and 1982) claim that Islamic bankers are increasingly exposed to risk due to equity-based financing, however Islamic scholars believe that the elimination of interest increases stability. In financial theory a linear relationship exists between risk and return, meaning that low risk is associated with low return and high risk brings about high return (Chapra, 1992).

Risk is a key component of making investment and investors share the risk involved with those carrying out investment activities. Islamic finance provides depositors with some influence on investment decisions and gives banks and financial institutions ashore in the decision making process. This allows both risk and decision making to bedspread over a much larger number and variety of people, allowing wider involvement .

In a study by Turen (1996) on the risk analysis of Islamic banks, he states that as interest is abolished for deposit holders and replaced by profit-sharing, the fixed interest payment is minimized or eliminated and therefore Islamic banks experience higher coverage of interest charge ratios and therefore lower financial risks. A further study by Samad and Hassan (1997) that compares an Islamic bank with a group of conventional banks shows that Islamic banks are less risky than conventional banks. Sarker (1997), however, found that the risk involved in profit sharing is very high, but states that many external factors and obstacles interfered with the proper implementation of the Islamic banking system. Sarker (1997), Samad and Hassan (1997), concluded that if Islamic banks are supported with appropriate banking laws and regulation, they can provide efficient banking services which encourage economic development. From the literature it is evident that both theoretically and empirically, economists find Islamic banking viable, acceptable and also efficient and significantly effective in developing the economy.
Accounting system in Islamic banks

Section 1 Current accounts

All Islamic banks operate current accounts on behalf of their clients: individuals and business firms. These accounts are operated for the safe custody of deposits and for the convenience of customers. There is little difference between conventional banks and Islamic banks as far as the operation of current accounts is concerned. However, the main characteristics of these accounts, as operated by Islamic banks, are listed below:

i. Current accounts govern what is commonly known as call deposits or demand deposits. These accounts can be opened either by individuals or companies, in domestic currency or in foreign currency if the bank is allowed to operate in the foreign exchange market and the holding of current balances in foreign currency is legal under the law of the land.

ii. The bank guarantees the full return of these deposits on demand and the depositor is not paid any share of the profit or any other return in any form.

iii. Depositors authorize the bank to utilize their funds at the bank's own risk. Hence, if there is any profit resulting from the employment of these funds, it accrues to the bank and if there is any loss, it is also borne by the bank.

iv. With these accounts, there are no conditions with regard to deposits and withdrawals.

v. Usually account holders have a right to draw checks on their accounts.

There are two dominant views about current accounts. One is to treat demand deposits as Amanah. This view is adopted by the Jordan Islamic Bank which operates a "Trust Account" instead of a current account. A trust deposit is defined by the Jordan Islamic Bank as "cash deposits received by the bank where the bank is authorized to use the deposits at its own risk and responsibility in respect to profit or loss and which are not subject to any conditions for withdrawals or depositing. Thus, these deposits are handed over to the bank by depositors as a Trust and the bank does...
not have the authority to use them without first obtaining the specific permission of the owner of the funds. The other view is to treat demand deposits as Qard Hasan. This view has been adopted by Iranian Islamic banks which call the current account Qard Hasan current account. According to this view, money deposited in these accounts is a benevolent (or interest free) loan (Qard Hasan) from the depositor to the bank. The bank is free to utilize these funds at its own risk without any return to the depositor and without needing any authorization because in the case of Qard Hasan, the debtor does not need the specific permission of the creditor to use the borrowed funds. The debtor owes the creditor only the principal amount borrowed. This condition is fulfilled as the amount deposited in these accounts is fully underwritten by the bank.

Section 2 Savings deposits

Although all Islamic banks operate saving accounts, there are some differences in the operation of these accounts. A typical example is that of the Bank Islam Malaysia, which defines savings deposits in the following way: "The Bank accepts deposits from its customers looking for safe custody of their funds and a degree of convenience in their use together with the possibility of some profits in the form of Saving Accounts on the principle of Al Wadia. The bank requests permission to use these funds so long as these funds remain with the bank. The depositors can withdraw the balance at any time they so desire and the Bank guarantees the refund of all such balances. All the profits generated by the Bank from the use of such funds belong to the portion of the Bank. However, in contrast with the current account, the Bank may, at its absolute discretion, reward the customers by returning a portion of the profits generated from the use of their funds from time to time."

It must be pointed out that any return on capital is Islamically justified only if the capital is employed in such a way that it is exposed to a business risk. If savings depositors are guaranteed that their amounts will be refunded in full, if and when they want them, as is the case with traditional banks, then, they are not participating in a business risk. Under these circumstances, it has to be made clear that savings depositors are not Islamically entitled to any return. If an Islamic bank refunds some portion of the profits generated from the use of saving deposits to the depositors, it is absolutely at the discretion of the bank concerned and it must be treated as a gift. It is
quite clear from the above quotation that this is exactly the course of action adopted by the Bank Islam Malaysia.

In contrast to this, the Bahrain Islamic Bank calls these accounts "Savings Accounts with Authorization to Invest". Depositors provide the bank with an authorization to invest their money. Depositors have the right of withdrawal, but profits are calculated on the basis of the minimum balance maintained for a month.

Similarly, savings accounts at the Dubai Islamic Bank operate as follows:

i. Savings accounts are opened with the condition that depositors provide the bank with an authorization to invest.

ii. Depositors have the right to deposit and withdraw funds.

iii. The profits in savings accounts are calculated on the minimum balance maintained during the month. Depositors participate in the profits of savings accounts with effect from the beginning of the month following the month in which the deposits are made. Profits are not calculated with effect from the beginning of the month in which a withdrawal is made from the account.

iv. A minimum balance has to be maintained in order to qualify for a share in profits.

The Iranian Islamic banks include saving accounts in "Qard Hasan Accounts" and call them "Qard Hasan" deposits. The operation of these accounts is similar to that of savings accounts in the conventional system as far as the deposit and withdrawal of money by means of a savings account passbook is concerned. Although no dividends are due in the case of Qard Hasan deposits, Iranian banks use different promotional methods in order to attract and mobilize deposits. These include giving:

i. Non-fixed bonus either in cash or in kind.

ii. Exempting depositors from or granting discount thereto, in the payment of commissions and/or fees.

iii. According priority to customers in the use of banking facilities.

The Jordan Islamic Bank has adopted yet another way to operate savings accounts. It includes the savings deposits into an investment pool called joint investment accounts.

The foregoing discussion makes it clear that Islamic banks adopt one of the following practices in operating savings accounts:

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a) Accepting savings deposits on the principle of Al Wadia requesting
depositors to give permission to the bank to use these funds at
its own risk, but guaranteeing full return of deposits and sharing
any profits voluntarily

b) Accepting savings deposits with an authorization to invest and
share profits in an agreed manner for the period in which a required
balance is maintained

c) Treating savings deposits as Qard Hasan from depositors to the bank and
granting pecuniary or non pecuniary benefits to depositors

Section.3 Investment deposits

Investment deposits are Islamic banks' counterparts of term deposits or time
deposits in the conventional system. They are also called Profit and Loss Sharing
(PLS) Accounts or Participatory Accounts. However, they can be distinguished from
traditional fixed term deposits in the following manner

i: Fixed term deposits in the conventional system operate on the basis of interest,
while investment accounts in Islamic banks operate on the basis of profit sharing.
Instead of promising depositors a predetermined fixed rate of return on their
investment, the bank tells them only the ratio in which it will share the profits with
them.

How much profit each depositor earns depends on the final outcome of the bank's
own investment

ii. Fixed term deposits are usually distinguished from each other on
the basis of their maturities; while investment deposits can be distinguished on the
basis of maturity as well as on the basis of purpose, as it is possible to give special
instructions to the bank to invest a particular deposit in a specified project or trade

The main characteristics of investment deposits can be described as:

i. Investment accounts can be opened by individuals or companies
either in domestic or foreign currency provided that the bank is allowed to operate in
foreign exchange. Deposit holders do not receive any interest. Instead, they participate
in the share of the profits or losses

iii. Usually these accounts are opened for a specific period, e.g. three
months, six months, one year or more
iv. The return on investment is determined according to the actual profits from the investment operations of the bank and shared in an agreed proportion by depositors according to the amount of their deposits and the period they are held by the bank. As an accounting practice, the amount held in the account is multiplied by the period for which it has been employed and profits are distributed on a pro rata basis.

v. Generally speaking, depositors do not have the right to withdraw from these accounts as is customary in time deposits in conventional banks. However, withdrawals may be made under special circumstances with the depositor forfeiting his share of the profit for the withdrawn amount.

vi. Usually, banks insist on a specified minimum amount to open and maintain the investment account.

vii. Most banks issue an investment certificate to depositors stating the terms and conditions of the deposit. Islamic banks have been experimenting with different kinds of investment deposit schemes in order to satisfy the needs and requirements of different kinds of investors. Some of these are described in this paper, but it is necessary to mention that most of these innovations are bank-specific. Hence, all of the different kinds of investment deposit may not be found in any given bank.

Section 4 Joint/General Investment Account

The most prevalent practice among Islamic banks is to establish some kind of investment pool in lieu of fixed term deposits. The investment pool takes the form of a general investment account in which investment deposits of different maturities are put together. These are not tied to any specific investment project but are utilized in different financing operations of the bank. Profits are calculated and distributed at the end of the accounting period, which is either three months, six months or one year. Another variation of the investment pool is the establishment of a "Joint Investment Account" which is defined by the Jordan Islamic Bank as "cash deposits received by the bank from persons desiring to participate with the bank in multilateral and continuous investment and financing operations, whereby such deposits will receive a certain percentage of annual profits realized in accordance with the conditions of the deposit."
account under which they are entered. Furthermore, Section 13(a) of the Law governing the Jordan Islamic Bank states that "cash deposits in investment accounts opened by the bank shall constitute part of the total cash resources of the bank to be used in financing operations" and shall be designated as "Joint Investment Account". Joint investment accounts of the Jordan Islamic Bank are further classified into savings accounts, notice accounts and fixed term accounts. It is also necessary to mention that profits and losses relating to financing from joint investment accounts are kept separate as an accounting practice from other income and expenditure resulting from other activities.

Section.5 Limited Period Investment Deposits

These deposits are operated by the Bahrain Islamic Bank and the Kuwait Finance House. Investment deposits under this scheme are accepted for a specified period which is mutually determined by the depositor and the bank. The contract terminates at the end of the specified period, but profits are calculated and distributed at the end of the financial year.

Section.6 Unlimited Period Investment Deposits

These investment deposits differ from limited period deposits in that the period is not specified. Deposits are automatically renewable unless a notice of three months is given to terminate the contract. No withdrawals or further deposits are permitted in this kind of contract, but customers are allowed to open more than one account. The profits are calculated and distributed at the end of the financial year.

Section.7 Specified Investment Deposits

Some Islamic banks have developed an investment deposit scheme with specific authorization to invest in a particular project or trade. In this case, only the profits of this particular project are distributed between the bank and its customers according to mutually agreed terms and conditions. In the case of specified investment accounts, Islamic banks function as an agent on behalf of depositors. This is evident in the provisions of the Jordan Islamic Bank which declares that the bank will accept cash deposits into specific investment accounts "from persons desiring to appoint the bank as agent for investment of these deposits in a specific project or in a specific manner on the basis that the bank will
Chapter FOUR

Success and Challenges facing Islamic banks

Section.1 challenges facing Islamic banks

Islamic banking industry has been trying for the last over two decades to extend its outreach to bring it at least to the level of conventional banking. But the absence of Shariah-compliant legal framework — needed to make interest-free banking acceptable (and create sound financial institutions) — is the major snag behind its low penetration in the financial market. It is the time to take stock of challenges faced by the Islamic banks as they need a number of supporting institutions/arrangements to perform functions which are being carried out by various financial institutions in the conventional framework. Attempts should be made to modify the existing structure to provide better products and quality service within the ambit of Islamic laws. Some of the most important challenges facing the Islamic banking industry are identified as follows.

Legal Support: Islamic law offers its own framework for execution of commercial and financial contracts and transactions. Nevertheless, commercial banking and company laws appropriate for implementation of Islamic banking and financial contracts do not exist. Islamic banking contracts are treated as buying and selling properties and hence are taxed twice. The commercial, banking and company laws contain provisions that are narrowly defined and prohibit the scope of Islamic banking activities within conventional limits. It is necessary that special laws for the
introduction and practice of Islamic banking be put in place. The legal framework of
Islamic banking and finances might include the following

a. Islamic banking courts: The disputed cases of the Islamic banks are subject to
the same legal system and are dealt with the same court and judge as the conventional
one while the nature of the legal system of Islam is totally different. To ensure a
proper, speedy and supporting Islamic legal system, amendments in existing laws,
which are repugnant to injunctions of Islam, are required to promulgate Shariah
compliant law for resolution of
disputes through special courts

b. Amendment of existing laws: Islamic banking has some kind of resemblance
to universal banking, therefore, laws and regulations have to be amended accordingly
to accommodate this new concept such as sections 7 (forms of business in which the
banking company can engage) and 9 (prohibition of trade) of the Banking Companies
Ordinance 1962 while Islamic banks are big or wholesale traders in reality

c. Islamic banking law: In the absence of Islamic banking laws, the enforcement
of agreements in courts may require extra efforts and costs. Therefore, banking and
companies’ laws in several countries require suitable modifications to provide a level
playing field for Islamic banks. Furthermore, international acceptance of Islamic
financial contracts requires them to be Shariah compatible as well as acceptable under
the major legal regimes such as Common law and Civil law systems.

d. Islamic banking balance sheet: Islamic banks do not show assets financed
through Ijara, Murabah etc., on balance sheet because section 7 of Banking Ordinance
1962 does not allow a bank to own property or asset which section 9 prohibits to enter
into any kind of trade. However, all the assets owned by Islamic banks be mentioned
in their balance sheets.

e. Monthly payment agreement: The housing finance is executed on the basis
of Diminishing Musharaka by the Islamic banks. Under this mode the house is
jointly owned by the bank and the customer. The bank rents out its share to the
customer on Ijara basis. The Islamic bank while executing Ijara with the
partner/customer, uses the term ‘Monthly Payment Agreement’ instead of having the
Ijara agreement with the customer. It is so named as to safeguard the bank’s interest in
case of refusal by the customer to pay rentals. No legal cover is provided to the
Islamic bank to overcome this risk.

f. **PLS deposits.** Deposits in Islamic banks are usually based on principle of profit
and loss (Musharaka or Murabaha). If something happens and the bank suffers loss it
has to be transferred to the depositor directly. This fear of loss is the biggest barrier to deposit mobilization in Islamic banks. In
some cases, it leads to withdrawal of funds. The depositors should be provided with
some kind of protection. Islamic prudential regulations: Supervision of Islamic banks
is equally important. At present, lack of effective prudential regulation is one of the
weaknesses of the Islamic banking industry. For instance, leasing prudential
regulations are applied to Ijara where the nature of both is different, such as taking
advances. The bank is the owner in Ijara; so taking advances will render the contract
of Ijara for conversion into Musharakah whereas the rules of Ijara are applied to it,
which is illegal. And some of the Islamic banks are using the term of security, hence
making the Ijara contract non-Shariah compliant as using the deposited sum under the
heading of Ijara security (‘Rahn’) is nothing but Ribawhich is strictly prohibited by
Islam. Moreover, Ijara financing is subject to compulsory insurance which is
essentially prohibited.

**g. Risks.** The nature of risk in Islamic banking is different from those of conventional
banking and therefore some special prudential, accounting and auditing standards
should be applied to them. Benchmark: Taking the conventional interest based
benchmarks (Kibor etc.,,) as the base
of pricing an Islamic financial product puts Islamic banks at the mercy of their
conventional peers. A negative perception is created among the clientele that there is
no prudent difference in Islamic bank products as these are also using the same
interest based benchmark. The mechanism for long-term financing could be devised
on the basis of prevailing renting system adopted by the private landlords while
renting their
assets/properties etc. Shariah based product: All Islamic financial institutions offer the
same basic products,(90 per cent Murabaha and Ijarah) but the problem is that each
institution has its own group of Islamic scholars on the Shariah board to approve the
product. Consequently, the very same product may have different features and will be
subject to different kind of rules in these institutions. Lack of standard financial
contracts and products can be a cause of ambiguity and a source of dispute and cost. In addition, without a common understanding on certain basic foundations, further development of banking products is hindered. Nature of Islamic banking: Islamic banks are offering only Murabaha and Ijarah while leaving the core and difference making Islamic financial instruments such as Musharakah and Murabah. It is necessary to enhance and facilitate the implementation of real Islamic banking activities i.e. promoting risk sharing through equity type facilities on the asset side and profit sharing investment accounts on the funding side. Lender of last resort facility: Islamic banks are reluctant to enter into long-term transactions due the lack of availability of liquidation through secondary market. There is liquidity support in the form of lender of last resort facility. There is no proper mechanism of transparency and disclosure to the public in order to ensure consumer protection as provided by Shariah. Islamic future exchange: In conventional system, long-term finance is provided through long-term bonds and equities. Apart from the general public, the most important source of these long-term investments are investment banks, mutual funds, insurance companies and pension funds. Islamic banks do not deal with interest bearing bonds. Therefore, the ironed for equity markets is much higher. On the top of it, the most of the products in Islamic banks are based on goods and commodities while prices and currency rates go up and down frequently, creating a big risk for them being traders in reality especially in the case of Salam and Istisna'a. To hedge the risk, they are in need of derivative products and consequently of Future Exchanges.

Section.2 Success of Islamic Banks

In this section we present some factors inherent to the success of Islamic banks as follows:

Factors of Success

- Banking Efficiency:

Banking efficiency is the extent to which a bank’s management is able to increase its assets and maximize its profits in the long-term, which is the more important, and in the short-term, which is also important. There is no doubt that the Islamic bank is fundamentally different from the conventional bank in the nature of its relationship with its depositors - a relationship of partnership not of negotiation, although so many
bankers, even those associated with the Islamic banks, behave as if these two different kinds of relationships are the same. This different nature of bank/depositor relations suggest that the management policy of an Islamic bank should to be fundamentally characterized by the maximization of both shareholders profit and depositors’ profit.

b. High Level of Trust

The reputation of management and founders is an issue that does not need reemphasis. It is evident that trust is the first foundation for the success of any bank. In addition, the Islamic bank also has the reputation of the Shari’ah board. Adherence to the Shari’ah in the banking and finance has become a familiar issue that does not require new juristic reasoning, especially after new standards issued by Bahrain-based Accounting and Auditing Organization for Islamic Financial Institutions. What every Islamic bank requires, today, is real and effective supervision on the implementation of standards and collective religious rulings in their actual deals and transactions with others including customers, depositors and shareholders, as well as effective Shari’ah supervision on innovations by the financial engineering department.

There are Islamic financial institutions in Sudan, United Arab Emirates, Kuwait, etc. have recently implemented this concept.

c. Efficiency of Investment, Financial engineering and Marketing Departments

These three departments should be well equipped, trained and prepared. The investment department generates revenues for both shareholders and depositors and it is the one that directly influences the bank’s profitability. It must be accountable for the task of continuously raising two indices: the investment index (invested assets to total assets) and the index of earnings to assets that measures investment return while it is constrained by the two principles of yield stability and capital preservation.

Preservation of Bank’s and Customers’ assets

This is the responsibility of the departments of liquidity and investment under direct supervision of the top management of the Islamic bank.

d. Providing Humanitarian and Social Services

Integration in its local environment/community is an important factor of success for the Islamic bank. This must be more characteristic of Islamic than conventional banks since the “raison d’être” of the former is to accommodate the community’s faith and beliefs. Additionally, research studies have shown that the more community sensitive a bank is the more profitable it will be in the long run. The social and humanitarian
responsibilities of Islamic banks are, no doubt, bigger than their conventional counterpart because of the moral values and societal ideals to which they adhere aside from the compulsory Zakah.

**Empirical extent of success 2.2**

An empirical survey was conducted on customers of Faisal Islamic Bank of Sudan (FIBS).

These findings reveal that the effective reasons for the success of Islamic banks are:

1. High and efficient bank services
2. Cheap and less risky advances on a participation basis
3. Higher return to customers on their investments
4. Low risk in returns

These factors seem similar to the usual expectations of any bank’s customers. The only difference between the two is related to the kind of loans to customers. While interest-based banks offer loans on a fixed return (interest), Islamic banks offer funds on participation basis.

Official of at the Saudi Islamic Development Bank Dr. Nabil Ghellab pointed out that Islamic financial institutions overcame the global financial crisis because of its investment technique leading to its spread across the globe, pointing out to the advantages of Islamic banking such as its commitment to the government systems and legislations of the countries where it works.

The biggest Islamic banking market is held by Saudi Arabia. However, after the Middle East, Malaysia emerges as the leading nation in the Islamic banking system, due to its organization and long-term vision.

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Conclusion

The theory and practice of Islamic banking are attracting worldwide attention at the present moment. Establishment of a new pattern of banking which is radically different from the conventional one is a formidable task, and the degrees of freedom in fashioning the new accounting system are also limited because all the techniques have to conform to shari'ah. The theoretical literature on Islamic banking that has become available in recent years has shown the way in which a truly distinctive form of banking, which is fully in line with the ethos of the value system of Islam, may be established. The theoretical literature has also taken note of the various misgivings and sought to examine them in an objective manner. The likely socioeconomic consequences of adopting the Islamic system of banking and finance have also been thoughtfully analyzed. Along with the theoretical developments, the practice of Islamic banking has been growing rapidly, and there have been a number of contributions shedding light both on the operating procedures of Islamic banks as well as the results achieved in terms of deposit mobilization, profitability and achievement of Islamic socioeconomic objectives.

Peoples' belief in Islam is acknowledged to be the main reason for the success of the system, but empirical survey reveals that other important reasons exist. Muslim people who supported the system formed expectations and found these expectations fulfilled are identified to have four objectives; (1) high level of banking services, (2) less risky advances, (3) reasonably high returns on investments and (4) low risk of returns. Fulfilling these objectives is the most important way of ensuring the future success of the system (even in non-Muslim countries).

Islamic banks are shown to be capable of fulfilling these objectives. Project financing, which seems to have become an integral feature of Western banking, enables Islamic banks to earn substantial profits and to acquire sufficient returns for its depositors. It is also shown that the Islamic participatory financing method provides relatively low-geared method of obtaining fund for risky projects.

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